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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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THE MARKET Letter 228 noted "the strong technical condition" of the market. That situation continues as of this writing. The short interest on the N. Y. S. E. is now just under 6 million shares, the short interest ratio has a bullish flavor at 1. 61, the odd-lotters are skeptical of the rise and continue to sell more stock than they purchase, and the debit loans (i. e., the total amount in margin accounts) remains near the highest levels in history (which means that professionals are betting on a further extension of the rise).

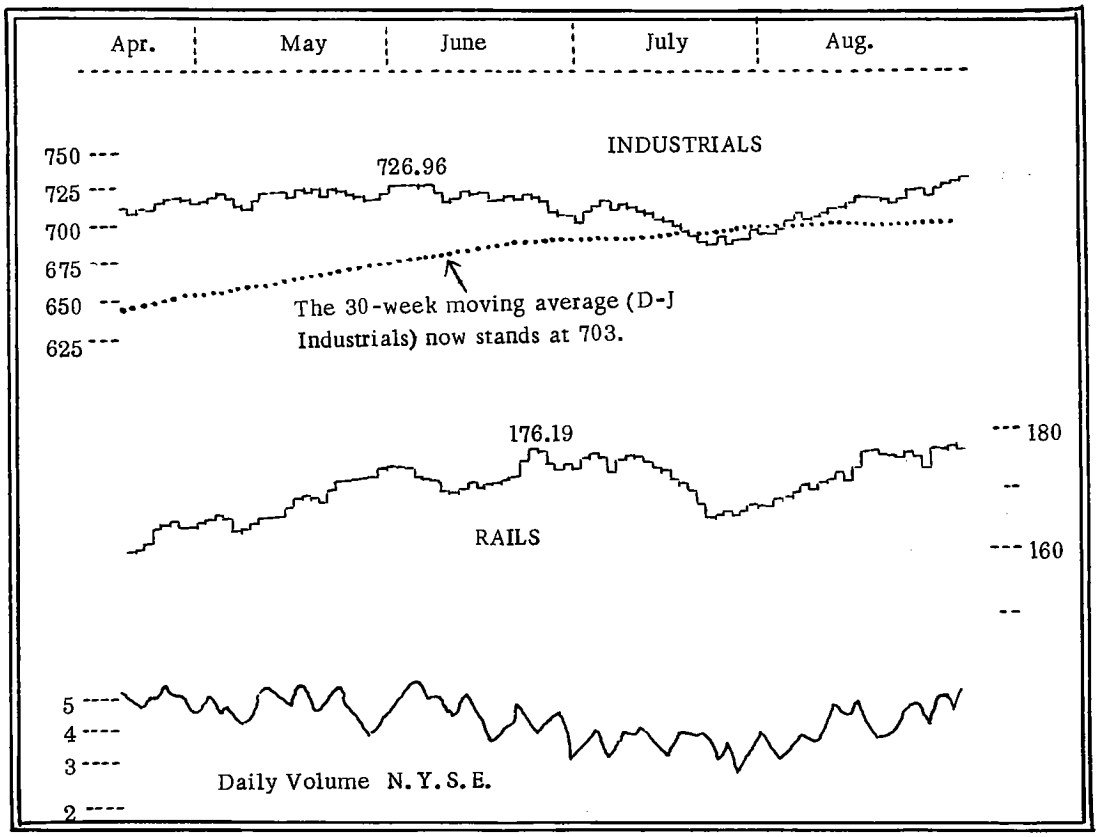
The last Letter also stated that the one thing which is now needed is "...corroboration from the price movement itself." In other words, it remains for the price movement to do what the technical condition of the market suggests it can do. A number of important price indexes have already risen to all-time highs, and these include the Associated Press Stock Average, the D-J 65 Stock Average, the S & P 500 Stock Average and the S & P 425. The fact that these comprehensive indexes have advanced to historic highs is, of course, bullish. Nevertheless, Dow's classic Theory deals with the movements of the D-J Industrial and Rail Averages, and it is with the implications of these two Averages that this writer prefers to concern himself.

The last confirmed highs of the advance were recorded on May 31, 1963 (Industrials at 726. 96, Rails at 176. 19). On August 16 the carrier Average bettered its May 31 peak. On August 30 Industrials confirmed by bettering their own 726. 96 level. Industrials have risen on 19 of the last 25 trading sessions, and it would now be normal to have a decline or consolidation. Regardless of possible hesitancy in this area, however, the joint confirmation above the May 31 peak (on good volume) suggests that the Averages shortly mean to assault their old bull market highs.

* * * * * *

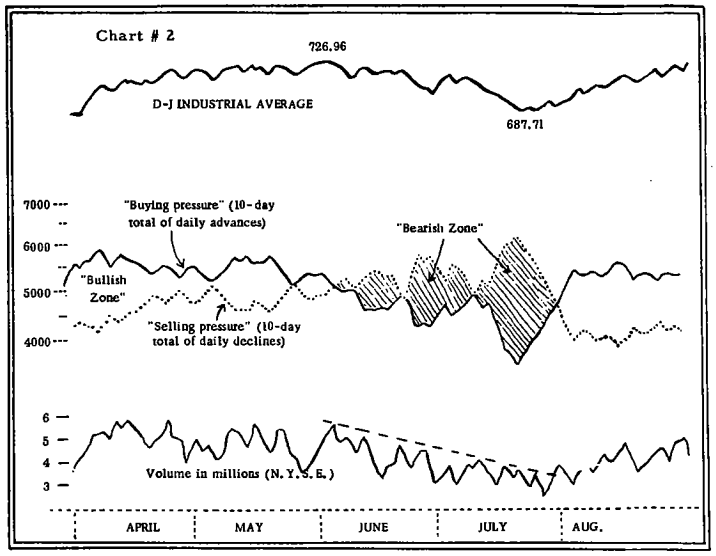
All in all, the market now finds itself in an extraordinary position. The Averages are within "shooting distance" of two historic peaks, one established seven years ago (the 1956 Rail high of 181. 23) and the other established two years ago (the 1961 Industrial high of 734. 91). Joint penetration of these two highs (in view of the months of odd-lot or public selling and in view of the large current short position) could produce "fireworks".

Three questions of overriding importance now face investors: (1) Will the two Averages rise to new highs and perhaps inflame the imagination of Wall Street and the country? (2) Will the public turn bullish in the period ahead and add a long-l ost speculative element to the market? (3) Should investors now take "insurance" against the possibility of an upside "explosion" in the market? I have attempted to examine these questions in the section entitled Low-Price Stocks.



BUYING AND SELLING PRESSURE As seen on Chart #2, buying pressure is holding steadily above selling and the two lines are now moving sideways. So far, buying pressure has not risen high enough (nor selling low enough) to give an "overbought" appearance to the market. As

long as the buying remains above selling the market can be considered to be in an upward trend. This sideways action can last for many weeks (as seen on the April-May-June section of this graph). First sign of potential danger would be a recrossing with selling pressure rising above the buying line again.



LOW-PRICED STOCKS There have been only four "crashes" in the last forty years -- 1929, 1937, 1946 and 1962. The automatic recoveries which followed the first three of these financial disasters failed to take the Averages to new (i.e., pre-crash) highs. The public (and many professionals) were badly hurt during 1929, 1937 and 1946, and many years passed before the market became speculative again. This is the reason why I wrote (Letters 206, 214) that following a crash, the public cannot normally be expected to enter the market again.

It is nevertheless possible that we will witness "something new" in market history, and that the Industrial Average will now climb above the 1961 all-time high of 734.91. Such action would mark the first time that a "crash-market" had been followed (within a few years or so) by new highs above the pre-crash peak.

From all sources I continue to hear that "the public does not like the fundamental picture", that the public thinks "stocks are too high", and that the public "simply does not trust the market". Furthermore, it is a fact that the public has been (and now is) depositing huge sums of money (at historically high rates of return) in savings and loan and banking institutions. But what will happen if new highs are shortly recorded by the Averages? Will this cause the public to change its mind and return en masse to Wall Street? The answer to this question is crucial -- and opens up the possibility of large profits (particularly in the public's favorite medium, the low-priced speculative issues).

If the public returns to the market, it is obvious that they will not buy stocks such as Corning Glass, Sears and American Telephone (except, perhaps, in odd-lot amounts). What they probably will buy is the lower priced speculative issues. Along these lines, it might be profitable to review the sequence of events which occurred a few years ago.

In April, 1956, Barron's Low-Priced Stock Index (see Chart #3) recorded a bull market peak of 150. A severe reaction occurred in late 1957, followed by a renewed advance. In September, 1958, Wall Street was electrified by a new high in Industrials above the famous triple top. At that time (September, 1958) Barron's L-P Index was 160. Following the new Industrial high, the public entered the market wholeheartedly. By April, 1959, Barron's L-P Index had risen to 250. In other words, the real money was made between September, 1958, and April, 1959, -- in low-priced stocks.

As I see it, this same possibility, the possibility of big profits in low-priced stocks, may again develop if Industrials now better their all-time high of 734.91.

It is of interest that Barron's L-P Stock Index is now 177 (Chart #3). After touching a low of 141 in October, 1962, this speculative Index has climbed only 36 points during the whole recovery movement! The reason is obvious. Barron's L-P Index moves when the public "moves". From this we can conclude that if Industrials go through their all-time high, and if the market becomes speculative again -- there will be ample time to purchase low-priced stocks. In fact, based on past history it is reasonable to conclude that the major part of a low-priced stock move could come after new highs are recorded by the Industrial Average.

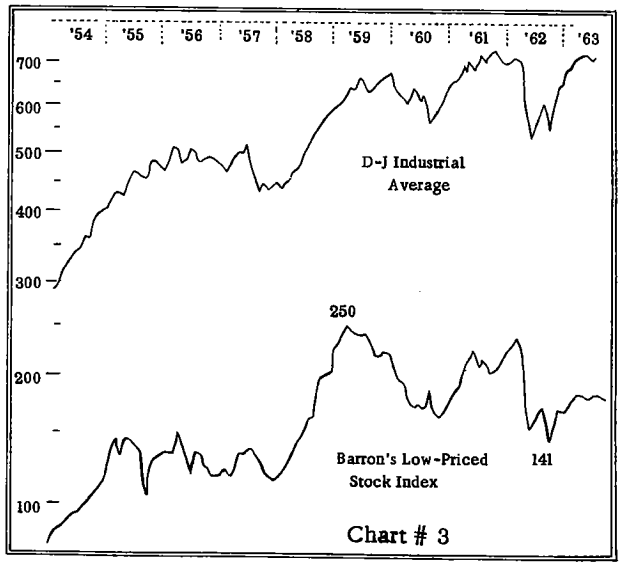


Chart # 3

In the last Letter I discussed the paradox of the post-1959 market. Since 1959 the bulls have been expecting "the final blow-off" and the bears have been expecting "the big collapse". As Industrials enter the fateful 715-735 zone again, this writer is watching (as I am sure most other analysts are) for signs of the long-awaited "final speculative binge".

In my opinion, the following set of "signals" would add up to a potential market explosion: (1) Rails going above their 1956 high of 181.23 with Industrials rising above their all-time high of 734.91. (2) Volume expanding to the 6 to 8 million share per day level. (3) Market news hitting the front pages of the newspapers again; "tips" and rumors coming back into fashion. (4) The odd-lot public slowly switching back to the buy-side of the market.

Will all this actually occur? No one can know for sure, but the above signs are the ones which I will be watching for. If this series does develop, the outlook for big profits in low-priced stocks will loom large again. It is for this reason that I have been discussing stocks in the lower price range (see stock section of recent Letters).

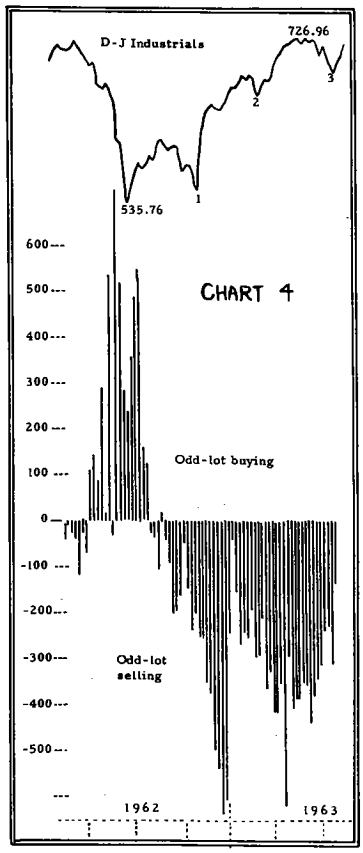


CHART 4

THE PUBLIC Chart #4 portrays a remarkable phenomenon and one which is closely allied to the preceding low-priced stock study. This chart shows the actual weekly S.E.C. figures of odd-lot transactions from early 1962 to the present. Vertical lines above zero indicate weeks in which odd-lot buying predominated; vertical lines extending below zero denote weeks of odd-lot selling.

As seen on the chart, during the 1962 crash there appeared a period of about fourteen weeks in which the odd-lot public bought quite heavily. Obviously the public judged the collapsing price structure of 1962 to be a perfect opportunity to "buy stocks cheap" (or at least at a substantial discount from their 1961-62 highs).

But as the decline assumed the proportions of a frightening collapse, the odd-lot public's initial optimistic reaction turned to one of doubt, then fear. By August, 1962 (following the "bottom"), the odd-lotters were beginning to swing to the selling side of the market. Note on the chart that these selling balances reached their greatest levels during the final weeks of 1962.

Odd-lot selling has continued throughout the year 1963, setting a record for sheer duration of selling which has not been matched in odd-lot history. What is the meaning of this huge area of concentrated odd-lot selling, this month after month of public retreat from the market?

Historically (with few exceptions) the correct interpretation of odd-lot selling during similar periods has been that stocks have been passing from uninformed (public) hands to informed (professional) hands. The question is: Has that same process been taking place during 1963? Has the apathy and general bearishness of the public corresponded with a period of professional and informed accumulation?

During late 1962 and 1963 there have been three attempts at reaction (marked 1, 2 and 3 on chart), but each decline stopped ¡ii above the previous decline bottom. This action suggests that (at least so far) stocks have been in strong hands. Point 3 on the chart identifies the recent 687.71 reaction low. The rally since then has taken both Averages back above their pre-reaction highs. The implication of such action (particularly in the face of continued odd-lot selling) is bullish.

MORE ON RELATIVE STRENGTH I have received an increasing amount of correspondence regarding relative strength. Relative strength (R.S.) is nothing more than the relative action of a stock or a group compared with the general market. It should be remembered that if a stock shows improving R.S., this fact alone does not imply that the stock is rallying or even in a rising price trend. But it does mean that the stock is performing well compared with the general market. For instance, during 1929-32 the chemical group showed outstanding relative strength, and that group's R.S. line rose sharply. Yet during 1929-32 chemical stocks declined in price. During the 1932-37 recovery chemicals continued their outstanding R.S. performance, and the chemical issues far outpaced the general market.

A recent example of this type of action (see chart #5) occured in 1962-63. During the '62 crash American Smelting showed improving R.S., and although the stock dropped sharply in price its R.S. line held its upward trend. Smelting's R.S. continued to improve during the recovery, and the stock far outperformed the market in 1963.

Relative strength patterns are often most dramatic when they actually diverge from the path of the general market. For instance, i American Smelting's R.S. line was moving up during all of 1962 as the market was heading generally down. Currently, the most drastic divergences are being shown by the Aircraft group, many of whose relative strength lines are dropping into new low territory for the past year -- even as the market heads higher. Such action suggests that Aircraft should be the leaders on the next decline. Strongest R.S. lines continue to be shown by Airlines, Autos, Textiles and Rails. Metal and Mining (see last Letter) also show improvement after turning bullish.

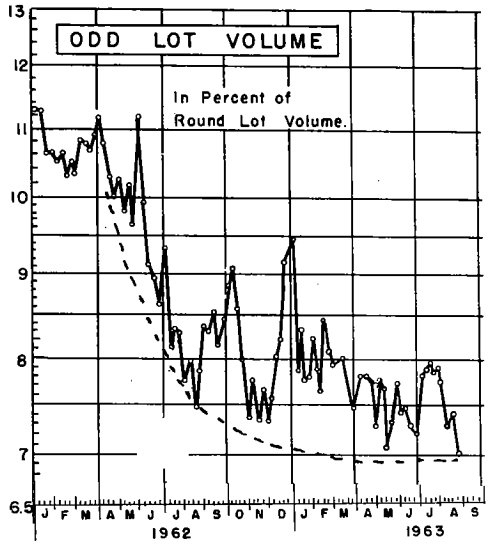


CHART OF THE WEEK The chart at right (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.) is quite extraordinary. It points up the fact that last week the odd-lot volume as a percentage of total N.Y.S.E. volume dropped to the lowest level in years! The public's interest in the market is now so monumentally low that one wonders whether a turn (to increased interest) is not near. Obviously, a rise in public participation is the single factor that is now needed in order to give life to the low-priced speculative stocks. Whether this will occur, I do not know, but if the Averages better their old highs in the weeks ahead, I would guess that the line on the accompanying chart will begin rising after its prolonged four year decline from the 1959 peak.

STOCKS Of 432 stocks which are tabulated weekly at this office, 347 or 78% are now holding above their 30-week moving average (a large increase of 10% from the last Letter).

In examining the price pattern of all stocks on both Exchanges, I have reached the following conclusions: (1) An amazing number of stocks on the American Exchange have not moved off their 1962-63 lows. (2) About 35% of the issues on the N.Y.S.E. are within 15% of their 1959-61, while the rest are in all stages of movement. (3) In general, least interest has been centered on low-priced speculative issues. (4) If speculative interest does expand, it is likely to envelop the N.Y.S.E. before it turns to the American. For this reason, I feel that lower-priced stocks on the senior Exchange now offer the best chances of appreciation in terms of percentages.

I have shown weekly charts of five stocks (below). There is an adage in the market (coined by me) which runs: "If you stay with Wall Street long enough, you will lose money on Sperry Rand." This stock's followers have had high hopes for it since the mid-1950's. When SY finally "took off" in 1961 no one could believe it. The disbelief was subsequently justified and SY collapsed in 1962. However, a large ascending triangle has formed in SY and this "crowd stock" could just work out again. SY usually moves when the public comes in. The professionals never seem to want to bid it too far, but at 17 I would buy it.

Burrough is outstanding for having done nothing but decline since its 1961 high of 53 5/8. The stock represents an improving situation although you would not know it from the price action. I suspect BGH has made a "double bottom" in the 24-26 area. Purchases of Burroughs should entail little risk and good odds for appreciation.

Conde Nast is one of the really better acting low-priced issues. Earnings have picked up, and the stock is beginning to move out on increasing volume. Relative strength of the publishing group has turned up after declining for two consecutive years.

General Bronze and Packaging Corp. are two other low-priced issues which I like at this time. General Bronze's relative strength line has turned up after declining for five years in a row. Packaging has risen above its long-term moving average after holding below this line for many months.

Chart of Sperry courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003. Other charts courtesy of Quote Digest, 110 North Lorraine, Wichita, Kansas